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Appearing Pro Hac Vice

UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF NEW YORK

In re BLOCKBUSTER INC., et al., Debtors.	Chapter 11 Case No. 10-14997-brl Jointly Administered Cases

Declaration of Don Herzog in Opposition to Debtors' Motion for Entry Of an Order, on an Interim and Final Basis, (I) Authorizing the Debtors to Obtain Postpetition Superpriority Financing Pursuant to 11 U.S.C. §§105, 361, 362, 364(c), 364(d)(1), and 364(e), (Ii) Authorizing Debtors' Use of Cash Collateral Pursuant to 11 U.S.C. § 363, (III) Granting Liens and Superpriority Claims to Dip Lenders Pursuant to 11 U.S.C. § 364, (IV) Providing Adequate Protection Pursuant to 11 U.S.C. §§ 361, 362, 363 and 364, and (V) Scheduling a Final Hearing Pursuant to Bankruptcy Rules 2002, 4001(b), 4001 (C), and 6004 [Docket 16, Filed 9/23/2010].

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I, Don Herzog, declare as follows:

1. I am a member of Creditor Lyme Regis Partners, LLC ("Lyme Regis"), a New York Limited Liability Company, and if called to testify I could and would testify of my own personal knowledge as to the following, except as to those matters that I state on information and belief and as to those matters, I believe them to be true.

2. On or about June 16, 2010, Lyme Regis purchased 9% Senior Subordinated Notes due 2012 in the open market ("Senior Notes").

3. On or about June 30, 2010, the value of these Senior Notes was impaired by the execution of a forbearance agreement ("Forbearance Agreement") between Blockbuster, Inc. ("Blockbuster") and holders of the 11.75% Senior Secured Notes due 2014 ("Secured Notes").

4. The Forbearance Agreement represents bad faith actions among holders of the Secured Notes and the management of Blockbuster, and was negotiated in order to add value to the Secured Notes at the unnecessary detriment to the holders of the Senior Notes. The Forbearance Agreement, among other things:

i) Specifically prohibited any cash payments legally due to holders of the Senior Notes;

ii) Specifically prohibited the sale of any Blockbuster assets, even non-core assets, despite the fact that Blockbuster had induced investment of its securities by touting

a non-core asset divestiture strategy;

iii) Specifically disavowed any waiver of default on the Secured Notes ("Default");

iv) Specifically allowed the holders of the Secured Notes to initiate accrual of default interest upon the imminent Default; and

v) Specifically afforded the holders of Secured Notes the asymmetrical benefit of weekly strategic reports, weekly financial reports, weekly restructuring reports, and weekly teleconference calls.

5. Despite the fact that over 22% of the Forbearance Agreement is dedicated to Blockbuster's representations and warranties, nowhere within the document does Blockbuster indicate that:

i) Blockbuster lacked sufficient capital to make the payments being waived by the Forbearance Agreement;

ii) Blockbuster otherwise lacked the ability to make the payments being waived by the Forbearance Agreement;

iii) The Forbearance Agreement was necessary to, or in any way assisted with, the continuation of operations of the corporation either in perpetuity or for any material period of time; and

iv) The Forbearance Agreement was necessary to assist, in any way, with a

strategy to maximize the value of the enterprise within or without bankruptcy protection.

6. The existence of such a questionable Forbearance Agreement leaves Lyme Regis to wonder if the agreement was deliberately formulated and executed to siphon value from the holders of Senior Notes for the benefit of the holders of Secured Notes. As stated above, there is no indication that Blockbuster was unable to make required payments to the holders of both notes. In fact, in a June 2, 2010 interview published in the Blockbuster June 3, 2010 Form 8-K, director, Gary Fernandes, as an inducement to potential debt and equity investors, said, it's also "premature" to speculate that shareholders will get nothing in any recapitalization and, "Obviously the stock price is way, way down, but Blockbuster still has decent earnings in terms of (earnings before interest, taxes, depreciation and amortization) that they're making every year[.]" Additionally, in the published interview he said that the fleet of stores is also still "very profitable." Despite such optimistic claims, the Forbearance Agreement spuriously disallowed payments to holders of the Senior Notes, while simultaneously guaranteeing the eventual collection of default interest to holders of the Secured Notes.

7. The questionably conspiratorial nature of Forbearance Agreement leads Lyme Regis to question the original intention of the Secured Notes. The Secured Notes were issued just over one year ago during a period in which the management of Blockbuster

and the purchasers of the Secured Notes knew or should have known that Blockbuster was experiencing fundamental business issues and needed a restructuring and/or divesting strategy. Despite this knowledge, or despite this knowledge being available, Blockbuster issued the Secured Notes for an amount in excess of the capital required to repay the debts it was purportedly using the capital to repay. (See, Blockbuster Inc. Form 8-K filed September 18, 2009 and Form 8-K filed October 5, 2009.)

8. The fact that the Secured Notes required repayment of the entire amount of indebtedness almost two years prior to the repayment date of the Senior Notes, and the fact that the Secured Notes allowed for an abbreviated time period prior to a partial redemption of the Notes being required as soon as July 2010 (a period of less than one year), leads us to believe that the Secured Notes were either:

i) simply used as a fraudulent extension of the corporation's life beyond insolvency, in which case the principle of deepening insolvency can be argued (See e.g., *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001)); or

ii) simply used as a convenient "loan-to-own" vehicle by the majority holders of the Secured Notes and facilitated by the current management of Blockbuster to curry favor with the soon-to-be new owners.

9. While it is possible that the portion of capital which was raised in excess of the

capital required to extinguish the debts purportedly being repaid (the "Excess Indebtedness") was to be used to fund a divesture plan as a way to "strengthen the company," as could be inferred from Blockbuster's investor materials just prior to the issuance (See, Page 18 of Blockbuster Inc. Investor Relations Presentation, September 2009), it should be noted that the structure of the Secured Notes and the subsequent forbearance agreements completely preempt any continuation of such strategy. Based on my review of the SEC filings, and public records of the company, I estimate the Excess Indebtedness to have been approximately $97,100,000.

10. Additionally, I believe the issuance of debtor in possession ("DIP") capital is unnecessary and unjustified with respect to financial analysis of the Blockbuster enterprise, and unjustified with respect to strategic analysis of the Blockbuster enterprise. DIP financing provided by entities affiliated with current holders of the Secured Notes raises questions of further deepening of insolvency and a means to unnecessarily siphon value from the holders of Senior Notes.

11. I understand from my review of the material that Debtor has already filed in this case, specifically, the proposed plan attached to the DEBTORS' MOTION FOR ENTRY OF AN ORDER, ON AN INTERIM AND FINAL BASIS, (I) AUTHORIZING THE DEBTORS TO OBTAIN POSTPETITION SUPERPRIORITY FINANCING PURSUANT TO 11 U.S.C. §§ 105, 361, 362, 364(c), 364(d)(1), AND 364(e), (II) AUTHORIZING DEBTORS= USE OF CASH COLLATERAL PURSUANT TO 11 U.S.C. §' 363, (III) GRANTING LIENS AND SUPERPRIORITY CLAIMS TO DIP LENDERS PURSUANT TO 11 U.S.C. §

364, (IV) PROVIDING ADEQUATE PROTECTION PURSUANT TO 11 U.S.C. §§ 361, 362, 363 AND 364, AND (V) SCHEDULING A FINAL HEARING PURSUANT TO BANKRUPTCY RULES 2002, 4001(b), 4001 (c), AND 6004, filed on September 23, 2010, as Docket 16, and the attachments to it, that the Secured Lenders, the Movie Studios, and the Debtor intend to propose a plan that would provide the 9% Senior Subordinated Notes due 2012 **no economic recovery**. Specifically, on the document entitled "Plan Term Sheet", the Debtors suggest that the note holders such as Lyme Regis receive the following treatment:

> The holders of those certain 9% Senior Subordinated Notes due 2012 issued by BBI (the "Subordinated Notes") shall not receive any distributions on account of their Claims (the "Subordinated Noteholder Claims") arising under or related to the Senior Subordinated Notes and that certain Indenture dated as of August 20, 2004 among BBI, the guarantors signatory thereto and The Bank of New York Trust Company, N.A. as Trustee (the "Subordinated Note Indenture").

(Docket 16, Term Sheet.)

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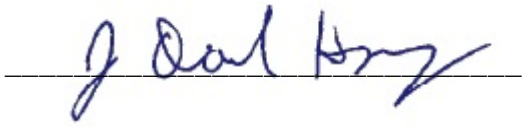
12. Clearly, Lyme Regis' entire investment would be impaired by the proposed plan - which has not even been vetted through the disclosure process, or been subject to the plan confirmation process.

I declare under the penalty of perjury according to the laws of the United States that the foregoing is true and correct and that this declaration was signed on October 12, 2010, at New York, New York.



Don Herzog

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	**Chapter 11**
BLOCKBUSTER, INC., *et al.*,	**Case No.: 10-14997 (BRL)**
Debtors.	**(Jointly Administered)**

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on October 12, 2010, a true and correct copy of the following documents were served upon all parties on the attached Master Service List via e-mail or United States first class mail, postage prepaid, as indicated, in accordance with the Federal Rules of Bankruptcy Procedure, and by e-mail upon the parties that receive notifications in this case pursuant to the Court's ECF system:

1. Opposition to Debtors' Motion for Entry Of an Order, on an Interim and Final Basis, (I) Authorizing the Debtors to Obtain Postpetition Superpriority Financing

Pursuant to 11 U.S.C. §§105, 361, 362, 364(c), 364(d)(1), and 364(e), (II) Authorizing Debtors' Use of Cash Collateral Pursuant to 11 U.S.C. § 363, (III) Granting Liens and Superpriority Claims to Dip Lenders Pursuant to 11 U.S.C. § 364, (IV) Providing Adequate Protection Pursuant to 11 U.S.C. §§ 361, 362, 363 and 364, and (V) Scheduling a Final Hearing Pursuant to Bankruptcy Rules 2002, 4001(b), 4001 (C), and 6004 [Docket 16, Filed 9/23/2010].

2. Declaration of Don Herzog in Opposition to Debtors' Motion for Entry Of an Order, on an Interim and Final Basis, (I) Authorizing the Debtors to Obtain Postpetition Superpriority Financing Pursuant to 11 U.S.C. §§105, 361, 362, 364(c), 364(d)(1), and 364(e), (II) Authorizing Debtors' Use of Cash Collateral Pursuant to 11 U.S.C. § 363, (III) Granting Liens and Superpriority Claims to Dip Lenders Pursuant to 11 U.S.C. § 364, (IV) Providing Adequate Protection Pursuant to 11 U.S.C. §§ 361, 362, 363 and 364, and (V) Scheduling a Final Hearing Pursuant to Bankruptcy Rules 2002, 4001(b), 4001 (C), and 6004 [Docket 16, Filed 9/23/2010].

Dated: October 12, 2010

THE MCMILLAN LAW FIRM, A.P.C.

/S/ SCOTT A. MCMILLAN

BY: _____
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(As of October 5, 2010)

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Debtors.	Jointly Administered Cases

Opposition to Debtors' Motion for Entry Of an Order, on an Interim and Final Basis, (I) Authorizing the Debtors to Obtain Postpetition Superpriority Financing Pursuant to 11 U.S.C. §§ 105, 361, 362, 364(c), 364(d)(1), and 364(e), (II) Authorizing Debtors' Use of Cash Collateral Pursuant to 11 U.S.C. § 363, (III) Granting Liens and Superpriority Claims to Dip Lenders Pursuant to 11 U.S.C. § 364, (IV) Providing Adequate Protection Pursuant to 11 U.S.C. §§ 361, 362, 363 and 364, and (V) Scheduling a Final Hearing Pursuant to Bankruptcy Rules 2002, 4001(b), 4001 (C), and 6004 [Docket 16, Filed 9/23/2010].

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Federal Decisional Authorities

Federal Statutes

Creditor Lyme Regis Partners, LLC, ("Lyme Regis")[1] hereby submits its Opposition to Debtors' Motion for Entry Of an Order, on an Interim and Final Basis, (I) Authorizing the Debtors to Obtain Postpetition Superpriority Financing Pursuant to 11 U.S.C. §§ 105, 361, 362, 364(c), 364(d)(1), and 364(e), (II) Authorizing Debtors' Use of Cash Collateral Pursuant to 11 U.S.C. § 363, (III) Granting Liens and Superpriority Claims to Dip Lenders Pursuant to 11 U.S.C. § 364, (IV) Providing Adequate Protection Pursuant to 11 U.S.C. §§ 361, 362, 363 and 364, and (V) Scheduling a Final Hearing Pursuant to Bankruptcy Rules 2002, 4001(b), 4001 (C), and 6004 [Docket 16, Filed 9/23/2010], herein "DIP Motion."

Debtor's DIP / Cash Collateral motion is much more than the title suggests. It actually is a broad motion encompassing past and future relations and litigation positions with the secured noteholders. The order on the motion purports to propose a release that is so broad that all of the pre-filing conduct of the Secured Lenders would be released.

The secured lenders put in place a forbearance agreement with the Debtor on June 30, 2010, that virtually ensured a bankruptcy, i.e., a "loan to own" agreement. (See, Herzog Decl. ¶ 8.) Now, the Debtor proposes to give the company to the secured lenders through this First Day Motion, ratifying what was a bad deal for Blockbuster's other

[1] Lyme Regis Partners, LLC, a New York Limited Liability Company, holds Debtor's 9% Senior Subordinated Notes due 2012. (Herzog Decl. ¶ 2.)

unsecured creditors at the outset.

Moreover, the DIP motion contains releases that will leave nothing left remaining for the confirmation of a plan. Indeed, the motion actually outlines the treatment of the parties in interest under a plan. Although not specifically argued within the body of the the Motion, the DIP motion will preclude the Debtor from seeking recourse against the secured lenders that benefit under this plan according to the releases contained within the proposed order, despite the possibility that the financial position that contributed to the bankruptcy actually arose from the conduct of the Secured Lenders.

I. INTRODUCTION

In this consolidated case filed on September 23, 2010, the Debtors appear to have structured their bankruptcy filing to transfer the value of Blockbuster into the hands of the Secured Lenders. Moreover, the entire body of Blockbuster, including its bundle of rights to avoid fraudulent transfers, is to be waived by the entry of this DIP financing order. The Debtor even has gone so far as to include an outline of the treatment of the various parties in interest according to the "plan," which has not even been preceded by filing Schedules of Financial Affairs, let alone a Disclosure Statement.

It is unclear what the Estate will receive in return for giving the Secured Creditors a super-priority lien and expansive releases against future lawsuits by this First Day Motion. If the Court were to grant this motion, it is unclear what rights the impaired

unsecured creditors would retain to resolve through the confirmation process.

The Debtors have simply ignored the interests of the bond creditors, and those trade creditors who are not movie moguls. Instead, the Debtors have focused on preserving the interests of the Secured Lenders, and some movie makers.

It is not fair.

II. BASIS FOR THE CREDITOR'S OBJECTION.

Lyme Regis is a party-in-interest, holding unsecured 9% Subordinated Notes. (Herzog Decl. ¶ 2.) By granting of the present motion, and adoption of the plan encompassed by the motion, Lyme Regis' entire investment would be eliminated. Thus, Lyme Regis is impaired by the proposed plan - which has not even been vetted through the disclosure process, or been subject to the plan confirmation process. (Herzog Decl. ¶ 12.)

On June 16, 2010 Lyme Regis purchased 9% Senior Subordinated Notes due 2012 in the open market ("Senior Notes"). On or about June 30, 2010 the value of these Senior Notes was impaired by the execution of a forbearance agreement ("Forbearance Agreement") executed between Blockbuster, Inc. ("Blockbuster") and holders of the 11.75% Senior Secured Notes due 2014 ("Secured Notes").

It is this Creditor's position that the Forbearance Agreement represents bad faith conduct among holders of the Secured Notes and the management of Blockbuster in that

the agreement was negotiated in order to add value to the Secured Notes at the unnecessary detriment to the holders of the Senior Notes. The Forbearance Agreement, among other things:

(i) Specifically prohibited any cash payments legally due to holders of the Senior Notes;

(ii) Specifically prohibited the sale of any Blockbuster assets, even non-core assets, despite the fact that Blockbuster had induced investment of its securities by touting a non-core asset divestiture strategy;

(iii) Specifically disavowed any waiver of default on the Secured Notes ("Default");

(iv) Specifically allowed the holders of the Secured Notes to initiate accrual of default interest upon the imminent Default; and

(v) Specifically afforded the holders of Secured Notes the asymmetrical benefit of weekly strategic reports, weekly financial reports, weekly restructuring reports, and weekly teleconference calls.

Despite the fact that over 22% of the Forbearance Agreement is dedicated to Blockbuster's representations and warranties, nowhere within the document does Blockbuster indicate that:

(i) Blockbuster lacked sufficient capital to make the payments being waived by the Forbearance Agreement;

(ii) Blockbuster otherwise lacked the ability to make the payments being waived by the Forbearance Agreement;

(iii) The Forbearance Agreement was necessary to, or in any way assisted with, the continuation of operations of the corporation either in perpetuity or for any material period of time; and

(iv) The Forbearance Agreement was necessary to assist, in any way, with a strategy to maximize the value of the enterprise within or without bankruptcy protection.

The existence of such a questionable Forbearance Agreement suggests an inference that the agreement was deliberately formulated and executed to siphon value from the holders of Senior Notes for the benefit of the holders of Secured Notes. As stated above, there is no indication that Blockbuster was unable to make required payments to the holders of both notes.

In fact, in a June 2, 2010 interview published in the Blockbuster June 3, 2010 Form 8-K, Blockbuster Director, Gary Fernandes, as an inducement to potential debt and equity investors, said, it's also "premature" to speculate that shareholders will get nothing in any recapitalization and, "Obviously the stock price is way, way down, but Blockbuster still has decent earnings in terms of (earnings before interest, taxes, depreciation and

amortization) that they're making every year[.]" Additionally, in the published interview he said that the fleet of stores is also still "very profitable." Despite such optimistic claims, the Forbearance Agreement spuriously disallowed payments to holders of the Senior Notes, while simultaneously guaranteeing the eventual collection of default interest to holders of the Secured Notes.

The questionably conspiratorial nature of Forbearance Agreement impugns the original intention of the issuance of the Secured Notes. The Secured Notes were issued just over one year ago during a period in which the management of Blockbuster and the purchasers of the Secured Notes knew or should have known that Blockbuster was experiencing fundamental business issues, and needed a restructuring and/or divesting strategy. Despite this knowledge, or despite this knowledge being available, Blockbuster issued the Secured Notes for an amount in excess of the capital required to repay the debts it was purportedly using the capital to repay.[2]

The fact that the Secured Notes required repayment of the entire amount of indebtedness almost two years prior to the repayment date of the Senior Notes, and the fact that the Secured Notes allowed for an abbreviated time period prior to a partial redemption of the Notes being required as soon as July 2010 (a period of less than one

[2] See Blockbuster Inc. Form 8-K filed September 18, 2009 and Form 8-K filed October 5, 2009.

year) raises an inference that the Secured Notes were either:

(i) simply used as a fraudulent extension of the corporation's life beyond insolvency in which case the principle of deepening insolvency can be argued (See e.g., *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001)); or

(ii) simply used as a convenient "loan-to-own" vehicle by the majority holders of the Secured Notes and facilitated by the current management of Blockbuster to curry favor with the soon-to-be new owners.

While it is possible that the portion of capital which was raised in excess of the capital required to extinguish the debts purportedly being repaid (the "Excess Indebtedness") was to be used to fund a divesture plan as a way to "strengthen the company" as could be inferred from Blockbuster's investor materials just prior to the issuance,[3] it should be noted that the structure of the Secured Notes and the subsequent forbearance agreements completely preempt any continuation of such strategy. Based on my review of the SEC filings, and public records of the company, Lyme Regis estimates the Excess Indebtedness to have been approximately $97,100,000.

Additionally, the issuance of debtor in possession ("DIP") capital is unnecessary, unjustified with respect to financial analysis of the Blockbuster enterprise, and unjustified

[3] Blockbuster Inc. Investor Relations Presentation, September 2009, page 18.

with respect to strategic analysis of the Blockbuster enterprise. DIP financing provided by entities affiliated with current holders of the Secured Notes raise questions of further deepening of insolvency and a means to unnecessarily siphon value from the holders of Senior Notes.

From the material that Debtor has already filed in this case, specifically, the proposed plan attached to the DEBTORS' MOTION FOR ENTRY OF AN ORDER, ON AN INTERIM AND FINAL BASIS, (I) AUTHORIZING THE DEBTORS TO OBTAIN POSTPETITION SUPERPRIORITY FINANCING PURSUANT TO 11 U.S.C. §§ 105, 361, 362, 364(c), 364(d)(1), AND 364(e), (II) AUTHORIZING DEBTORS USE OF CASH COLLATERAL PURSUANT TO 11 U.S.C. §' 363, (III) GRANTING LIENS AND SUPERPRIORITY CLAIMS TO DIP LENDERS PURSUANT TO 11 U.S.C. § 364, (IV) PROVIDING ADEQUATE PROTECTION PURSUANT TO 11 U.S.C. §§ 361, 362, 363 AND 364, AND (V) SCHEDULING A FINAL HEARING PURSUANT TO BANKRUPTCY RULES 2002, 4001(b), 4001 (c), AND 6004, filed on September 23, 2010, as Docket 16, and the attachments to it, that the Secured Lenders, the Movie Studios, and the Debtor intend to propose a plan that would provide the 9% Senior Subordinated Notes due 2012 **no** economic recovery. Specifically, on the document entitled "Plan Term Sheet", the Debtors suggest that the note holders such as Lyme Regis receive the following treatment:

> "The holders of those certain 9% Senior Subordinated Notes due 2012 issued by BBI (the "Subordinated Notes") shall not receive any distributions on account of their Claims (the "Subordinated Noteholder Claims") arising under or related to the Senior Subordinated Notes and that certain Indenture dated as of August 20, 2004 among BBI, the guarantors signatory thereto and The Bank of New York Trust Company, N.A. as Trustee (the

"Subordinated Note Indenture")."

(Docket 16, Term Sheet.)

Thus, the DIP financing order proposed will effect a cram down, without any confirmation process. The Secured Lenders will have simply taken over the Estate without demonstrating that the requirements of confirmation according to section 1129 were met. (11 U.S.C. § 1129.) Particularly, as to the requirement that a plan be "fair and equitable" in order to be adopted over the objections of an impaired class of creditors. (11 U.S.C. § 1129(b)(1).)

III. PROCEDURAL BACKGROUND

Debtors filed their proposed consolidated Chapter 11 Bankruptcy Petition on September 23, 2010. With that filing, Debtors filed several First Day Motions,[4] including

[4] Debtors take an aggressive stance in the First Day Motion filings, deviating from the standards in *In re Colad Group, Inc.*, 324 B.R. 208, 214 (Bankr. W.D.N.Y. 2005):

> First, the requested relief should be limited to that which is minimally necessary to maintain the existence of the debtor, until such time as the debtor can effect appropriate notice to creditors and parties in interest. In particular, a first day order should avoid substantive rulings that irrevocably determine the rights of parties.
>
> Second, first day orders must maintain a level of clarity and simplicity sufficient to allow reasonable confidence that an order will effect no unanticipated or untoward consequences.

(continued...)

the present Motion. Four days later, on September 27, 2010, this Court issued an interim order granting superpriority secured financing. (Docket 95, Filed 9/27/2010.)

Meanwhile, Debtors also successfully requested an order allowing them additional time in which to file the schedules of financial affairs ("SOFA"), which would contain information relating to preferential payments to creditors. (Docket 6, Filed 9/23/2010.) Within that request, Debtors requested that the 14 day-period provided under Rule 1007(c) be extended an additional 30 days. (¶ 7, Docket 6, Filed 9/23/2010.) The Court granted an additional extension of 15 days by Order issued that same day. (Docket 38, Filed 9/23/2010.) [5] Consequently, the SOFA will be due on Friday, October 22, 2010, well after the opposition date for the Final Hearing on the First Day motions.

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[4](...continued)
Third, first day orders are not a device to change the procedural and substantive rights that the Bankruptcy Code and Rules have established. In particular, first day orders should provide no substitute for the procedural and substantive protections of the plan confirmation process.

Fourth, no first day order should violate or disregard the substantive rights of parties, in ways not expressly authorized by the Bankruptcy Code.

[5] Order Pursuant to 11 U.S.C. § 521 and Fed. R. Bankr. P. 1007(c) Extending Time to File Schedules of Assets and Liabilities, Schedules of Executory Contracts and Unexpired Leases, and Statements of Financial Affairs, Docket No. 38, Filed 9/23/2010.

IV. STANDARDS ON A MOTION FOR AUTHORITY TO OBTAIN DIP FINANCING AND USE CASH COLLATERAL.

Cash Collateral:

The Bankruptcy Code, at 11 U.S.C. § 363, permits the debtor to use cash collateral without consent of those with an interest in it only if that interest is adequately protected. Case law provides that the standard to be used for determining whether to allow the use of cash collateral includes the following:

(1) The court must establish the value of the secured creditor's interest;

(2) The court must identify risk to the secured creditor's value resulting from the debtor's request for use of cash collateral; and

(3) The court must determine whether the debtor's adequate protection proposal protects value as nearly as possible against risks to that value consistent with the concept of indubitable equivalence.

(*In re Negus-Sons, Inc., 428 B.R. 511, 515* (Bankr. D. Neb. 2009) Cash collateral:

DIP Financing:

Section 364(d)(1) provides: "[t]he court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if --(A) the trustee is unable to obtain such credit otherwise; and (B) there is adequate protection of the interest of the holder of

the lien on the property of the estate on which such senior or equal lien is proposed to be granted."

11 U.S.C. § 364(d)(1), *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 441 (Bankr. S.D.N.Y. 2010).

Judge Gonzalez explained in *In re YL West 87th Holdings I LLC* that:

> "Generally, courts require only a showing of reasonable effort; debtors are not required to seek an alternative financing from every possible lender. It is up to each court to determine, on a case-by-case basis, whether a debtor's effort in seeking alternate source of financing meets the requirement under section 364.. The debtor bears the burden of proof under section 364(d)(1)(A)."

In re YL West 87th Holdings I LLC, 423 B.R. 421, 441 (Bankr. S.D.N.Y. 2010).

The evidentiary showing made in support of the effort to obtain "DIP" financing does not meet the standards required by section 364(d)(1)(A).

V. ARGUMENT

A. The proposed release of claims for fraudulent transfers are not supported by the law or the evidence.

1. The Debtors fail to support the motion with admissible evidence.

The sole evidentiary support for this Motion consists of three scant paragraphs (¶¶ 89-93) of the Affidavit of Jeffery J. Stegenga. Mr. Stegenga's affidavit itself shows that he lacks the requisite personal knowledge relating to the subject matter of this

Motion. Federal Rule of Evidence 602 provides that "[a] witness may not testify to a matter unless evidence is introduced sufficient to support a finding that the witness has personal knowledge of the matter." (See, *Granahan v. Christian* (2007) 2007 Bankr. LEXIS 926, citing Fed. R. Evid. 602.) Similarly, under Rule 701, "[i]f the witness is not testifying as an expert, the witness' testimony in the form of opinions or inferences is limited to those opinions or inferences which are (a) rationally based on the perception of the witness, and (b) helpful to a clear understanding of the witness' testimony or the determination of a fact in issue, and (c) not based on scientific, technical, or other specialized knowledge within the scope of Rule 702." (Fed. R. Evid. 701.)

As such, Mr. Stegenga lacks the requisite personal knowledge to testify concerning the supposed benefit of the requested relief, the most troubling of which are the releases that are not even mentioned in those three paragraphs, but are rather found in the exhibits to the DIP Motion.

Specifically:

> 1.17 Release. The Borrower and each other Credit Party hereby acknowledges effective upon entry of the Final Order, that the Borrower, the other Credit Parties and their respective Subsidiaries have no defense, counterclaim, offset, recoupment, cross-complaint, claim or demand of any kind or nature whatsoever that can be asserted to reduce or eliminate all of any part of the Borrower's or the other Credit Parties' liability to repay Agent or any Lender as provided in this Agreement or to seek affirmative relief or damages of any kind or nature from Agent or any Lender. The Borrower and each other Credit Party, each in their own right and on behalf of their bankruptcy estates, and on behalf of all their successors, assigns,

> Subsidiaries and any Affiliates and any Person acting for and on behalf of, or claiming through them (collectively, the "Releasing Parties"), hereby fully, finally and forever release and discharge Agent and Lenders and all of Agent's and Lenders' past and present officers, directors, servants, agents, attorneys, assigns, heirs, parents, subsidiaries, partners, members, managers, controlling persons and stockholders and each Person acting for or on behalf of any of them (collectively, the "Released Parties") of and from any and all past, present and future actions, causes of action, demands, suits, claims, liabilities, Liens, lawsuits, adverse consequences, amounts paid in settlement, costs, damages, debts, deficiencies, diminution in value, disbursements, expenses, losses and other obligations of any kind or nature whatsoever, whether in law, equity or otherwise (including, without limitation, those arising under Sections 541 through 550 of the Bankruptcy Code and interest or other carrying costs, penalties, legal, accounting and other professional fees and expenses, and incidental, consequential and punitive damages payable to third parties), whether known or unknown, fixed or contingent, direct, indirect, or derivative, asserted or unasserted, foreseen or unforeseen, suspected or unsuspected, now existing, heretofore existing or which may heretofore accrue against any of the Released Parties, whether held in a personal or representative capacity, and which are based on any act, fact, event or omission or other matter, cause or thing occurring at or from any time prior to and including the date hereof in any way, directly or indirectly arising out of, connected with or relating to this Agreement, the Interim Order, the Final Order and the transactions contemplated hereby, and all other agreements, certificates, instruments and other documents and statements (whether written or oral) related to any of the foregoing.

[Exhibit B to Motion, “SENIOR SECURED, SUPER-PRIORITY DEBTOR-IN-POSSESSION, REVOLVING CREDIT AGREEMENT,” Dated as of September 22, 2010, Page 15-16]

The affiant makes no effort to substantiate why this broad release is necessary to obtain the financing. Further, the motion lacks any description as to other sources of financing that the Debtor sought out.

2. The proposed exculpation clauses are unnecessary and imprudent, in light of the Debtors' failure to file the schedules.

The relief proposed by the Debtors improperly seeks to exonerate past transfers that have not yet been examined by this Court. First, Debtors have not fully disclosed the transfers, i.e. no schedules have been filed. Second, to the extent there were preferential transfers, the exculpation of those transfers contradicts the Court's avoidance powers under 11 U.S.C. § 547. As explained in *In re Smith*, 966 F.2d 1527 (7th Cir. Ind. 1992):

> First, the avoidance power promotes the "prime bankruptcy policy of equality of distribution among creditors" by ensuring that all creditors of the same class will receive the same pro rata share of the debtor's estate. H.R. Rep. No. 595, 95th Cong., 2d Sess. 177-78 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6137-39. Second, by providing for the recapture of last-minute payments to creditors, the avoidance power reduces the incentive to rush to dismember a financially unstable debtor. *Id.; Covey v. Commercial Nat'l Bank of Peoria*, 960 F.2d 657, 661-62 (7th Cir. 1992). See generally *In re Barefoot*, 952 F.2d 795, 797-98 (4th Cir. 1991).

(*In re Smith, supra*, at 1535.)

Ultimately, the creditor body may choose, by consensus, to agree to a reorganization plan whereby the Secured Lenders are forgiven for any preferential transfers they received. However, that is a disposition that should not be made in the context of a First Day Motion, particularly where the entire extent of the transfers has not been disclosed.

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3. Alternatively, any exculpation of the Secured Lenders for receipt of money transferred should be made by motion for approval of a settlement according to Bankruptcy Rule 9019.

To the extent the Debtors seek to reach a compromise with the transferees of any assets subject to an avoidance action, Debtors would need to make a motion under Bankruptcy Rule 9019 and section 363. Instead, Debtors merely inserted a broad exculpation clause into the petition, and seek to have that clause approved by the Court at the start of this bankruptcy action (and without disclosing the underlying facts supporting such relief).

"The benchmark for determining the propriety of a bankruptcy settlement is whether the settlement is in the best interests of the estate." (*In re Energy Coop*., 886 F.2d 921, 927 (7th Cir. Ill. 1989).) Although the court must give the judgment of the debtor in possession or trustee some discretion when determining whether to approve a settlement, "a court cannot simply approve a settlement because the trustee so wishes. [citation] The trustee must demonstrate sound judgment in advocating a settlement." (*In re Foundation for New Era Philanthropy*, 1996 Bankr. LEXIS 1891, 20 (Bankr. E.D. Pa. July 22, 1996).) Hence,

> [i]n considering a proposed compromise, the bankruptcy court is charged with an affirmative obligation to apprise itself of the underlying facts and to make an independent judgment as to whether the compromise is fair and equitable. *In re American Reserve Corp.*, 841 F.2d 159, 162-63 (7th Cir.

> 1987). The court is not permitted to act as a mere rubber stamp or to rely on the trustee's word that the compromise is "reasonable." *Id.* at 162.

(*Reynolds v. Commissioner*, 861 F.2d 469, 473 (6th Cir. 1988); See also, *In re A & C Properties*, 784 F.2d 1377, 1381 (9th Cir. Cal. 1986).)

The interrelated factors this Court must apply in approving a settlement – which is what this application to Motion clearly is – are set forth in the *Iridium* case:

> (1) the balance between the litigation's possibility of success and the settlement's future benefits; (2) the likelihood of complex and protracted litigation, "with its attendant expense, inconvenience, and delay," including the difficulty in collecting on the judgment; (3) "the paramount interests of the creditors," including each affected class's relative benefits "and the degree to which creditors either do not object to or affirmatively support the proposed settlement"; (4) whether other parties in interest support the settlement; (5) the "competency and experience of counsel" supporting, and "[t]he experience and knowledge of the bankruptcy court judge" reviewing, the settlement; (6) "the nature and breadth of releases to be obtained by officers and directors"; and (7) "the extent to which the settlement is the product of arm's length bargaining."

(*In re Iridium Operating LLC*, 478 F.3d 452, 462 (2d Cir. N.Y. 2007).)

Here, Debtors' Motion is devoid of any facts addressing these factors. There is no evidence supporting a capitulation by the Debtors to the Secured Lenders. There is no evidence demonstrating any benefit to be realized by the Debtors that would not be otherwise realized through renegotiation of the distribution agreements. The Court also lacks any evidence demonstrating any benefit to be realized by the other unsecured creditors. Debtors likewise fail to provide any basis for concluding that a settlement,

which provides for the waiver of claims based on unspecified fraudulent transfers, is fair and equitable to the creditor body as a whole.

Indeed, Debtors fail to describe how the waiver of these claims in particular, or the settlement in general, would benefit any creditor, which is a factor that the Court must consider. (See, *In re A & C Properties*, 784 F.2d at 1381.) This reorganization proceeding is new. The creditors have not even had an opportunity to participate in the 341 examination of the Debtors, yet the Debtors seek to eliminate the ability of the Estate to recover for fraudulent transfers made to the Secured Creditors. It is particularly troubling that Debtors would seek to enter into an agreement that waives the creditors' rights to proceed with actions based on fraudulent transfers in a First Day Motion.

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VI. CONCLUSION

For the foregoing reasons, Creditor Lyme Regis Partners, LLC respectfully requests that the Court deny Debtor's Motion to allow the overreach financing terms that the DIP motion proposes and exculpation of any fraudulent transfers that may have occurred. To the extent the Court is inclined to grant the Motion, Lyme Regis Partners, LLC respectfully requests that the Motion hearing be continued, with Debtor ordered to supplement the record by providing the supporting evidence which is omitted from the Motion, but needed for an informed decision on the Motion.

Dated: October 12, 2010

THE MCMILLAN LAW FIRM, APC

/s/ Scott A. McMillan

_____

Scott A. McMillan
Attorney for Creditor
Lyme Regis Partners, LLC